DYNASTY TRUSTS
What is a Multi-Generational Trust?

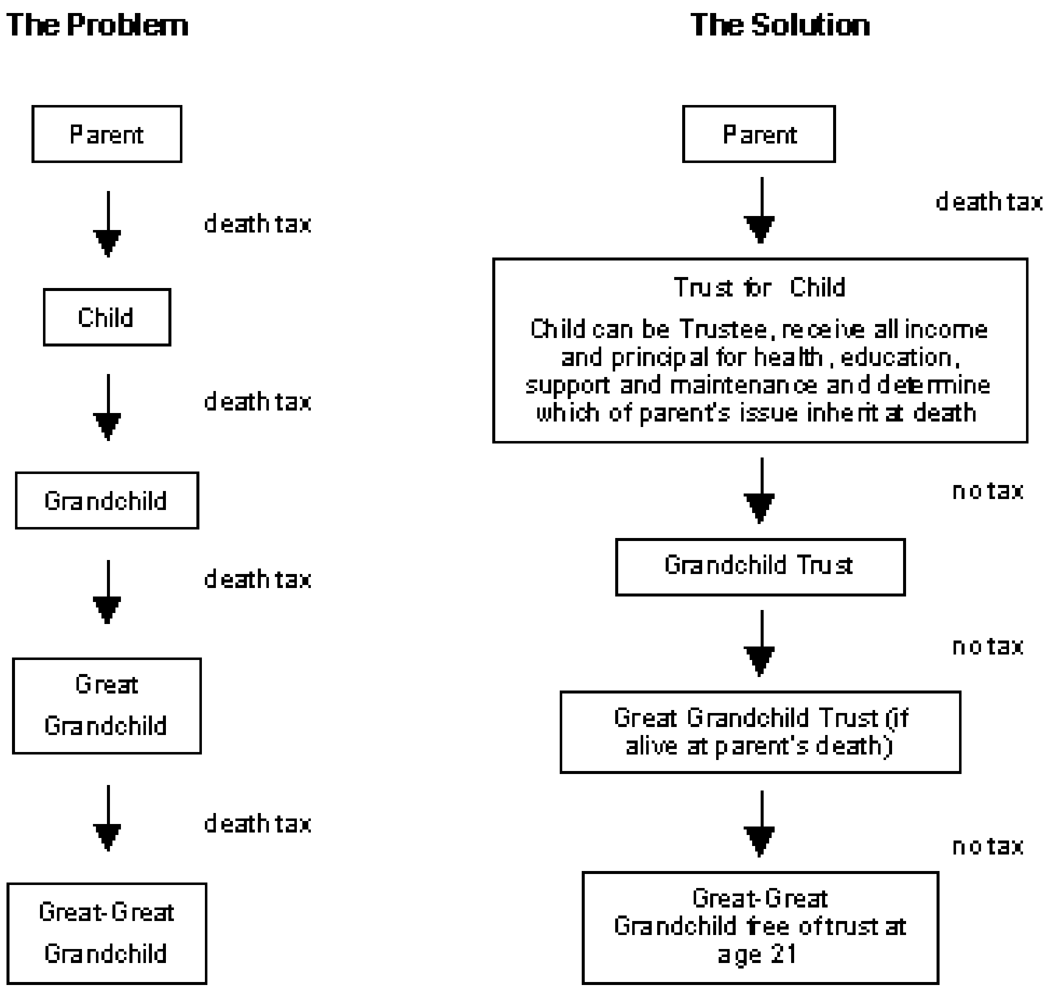
In its simplest form, a multi-generational trust is a trust in which the child who is a beneficiary of the trust dies during the term of the trust, and the property then passes on to his issue. (These trusts are also called "generation skipping trusts," but this is a misnomer since usually no generation is skipped.) When the trust is established, the parents can intentionally create this generation skip by providing that the assets will stay in trust for the child's entire lifetime and directing that the trust will then pass to the child's issue upon the child's death. The skip can also sometimes happen by accident. For instance, if a trust is created to distribute the trust principal outright to the child at a certain age such as 25 or 35 and the child happens to die before reaching that age, or if a QTIP is established for a surviving spouse and the child dies before the surviving spouse, there will be a generation skip if the trust provides that the child's share will pass to the child's issue.

It is also possible to establish a trust that will continue in existence for more than one generation. For example, the assets may benefit a child's child in trust, and at the grandchild's death the assets can be held in trust for the great-grandchild. However, the Rule Against Perpetuities limits how long the trust may last. The trust must terminate at least twenty-one years after the death of the last issue who was alive when the first parent died. Thus, if a great-grandchild is alive at the parent's death, the trust can continue until twenty-one years after that great-grandchild dies.

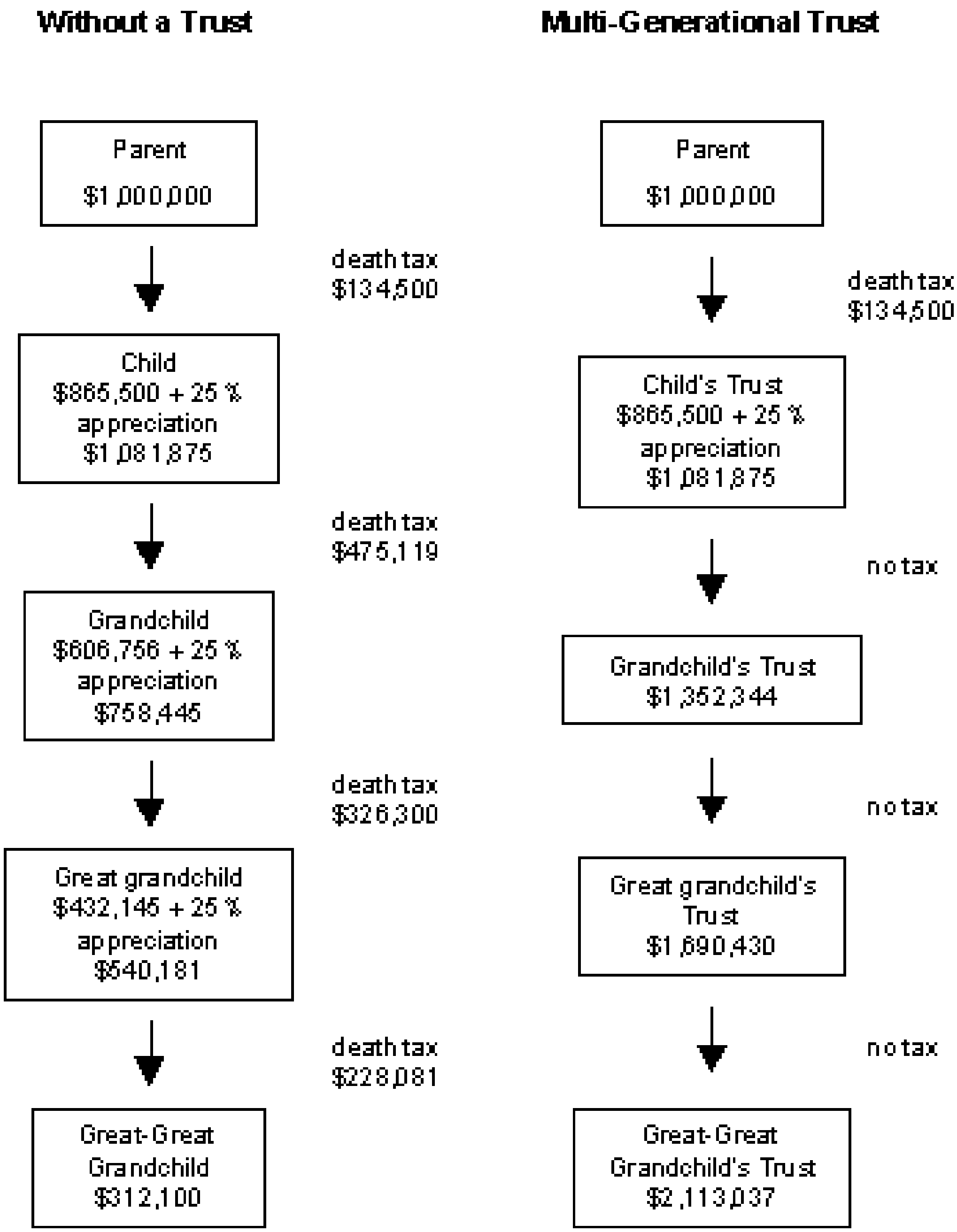
The Opportunities

Many people ask how the Du Ponts and the Rockefellers kept so much money for generations. When the estate tax was first imposed, wealthy families were used to arranging for their estates to stay in trust for as many generations as possible. Originally, the purpose of these trusts was to conserve the family assets while providing for unified management, and to prevent the family fortune from passing to anyone but direct descendants. The estate tax originally only taxed assets passing at death. Since assets held in irrevocable trusts were not considered passing at death, with the most minimal of planning families could avoid the estate tax as the fortune flowed down the generations.

Tax Advantages



As you can see from the diagram, the multi-generational trust is advantageous because it skips the estate tax as subsequent generations die and the estate passes on to the next generation. Let's see what this could mean in terms of dollars saved if we make the following assumptions: 1) assume the parent is worth $1,000,000 and the parent's estate (after tax) increases by 25% each generation; 2) assume each heir has an estate of $1,000,000 of his own (part of which would come from the income from his parent's estate); and 3) assume no change in the structure of the estate tax laws



As you can see from the rather starting effect of these numbers, with assumptions which are probably very conservative, after four generations with no planning, the $1,000,000 has changed to about $300,000 whereas with a multi-generational trust the $1,000,000 has grown to over $2,000,000. The government loses over $1,000,000 in tax which has been saved for the family.

Non-Tax Advantages

The multi-generational trust can also result in some significant non-tax advantages. The estate may consist of assets which should be held together in one entity, such as a business or portfolio of real estate or other investments. The multi-generational trust allows the assets to be held in trust for a considerable period of time rather than being broken up, sold or divided into small parcels for different family members. If one child or person is better suited than others to manage the assets, it is possible to draft the trust with a single trustee for the family. However, some parents prefer that each child be the trustee of his or her own trust and thus be totally in control of the investments for that child's share of the estate.

Many people setting up their estate plan appreciate the fact that the assets in the multi-generational trust do not have to be given to spouses of their issue. Thus the family can avoid the problems which often occur in divorce where commingled property is taken out of the family line. They can also avoid the problems that occur when the surviving spouse of a deceased child transfers property to a new spouse who is not a member of the family.

If the only desire is to prevent the death tax, the parents may give the children considerable control over the trust for each child's benefit. In addition to receiving all of the income, the children can be entitled to the principle for their health, education, support and maintenance. Thus if a child determines that he actually does need the funds, he can invade the principle of his trust. The parents can also give the children the power to determine which of the parents' issue and their spouses will inherit their trust at the children's death. The trust may be drafted to terminate when the trust benefits the grandchildren, which saves the tax for one generation. Or the trust instrument may stipulate that the assets will stay in trust for future generations, thus avoiding more estate taxes at each successive generation.

These trusts are set up as spendthrifts trusts so that the beneficiary's creditors cannot reach the trust assets. If the beneficiary is sued and loses, the trust cannot be taken to satisfy the judgment under current California law. If a parent's heirs are in dangerous professions, such as medicine, law or accountancy, this can be important protection for the heirs.

There is a great deal of flexibility in how these trusts are set up depending on each family's situation. Parents may choose to set up a multi-generational trust for one child but not others, either because of the parents' feelings about the child's ability to manage property or possibly because the trust is desirable for the child's own estate planning. If a child has already accumulated a significant estate, the child is probably already working to avoid as much estate tax as possible at his death. Additional assets received from a parent only aggravate the estate tax problem. The multi-generational trust can be drafted to be very flexible for the child in how it benefits the child and the child's spouse and issue, and yet still avoid being taxed in the child's estate. This helps the child accomplish his own estate planning goals.

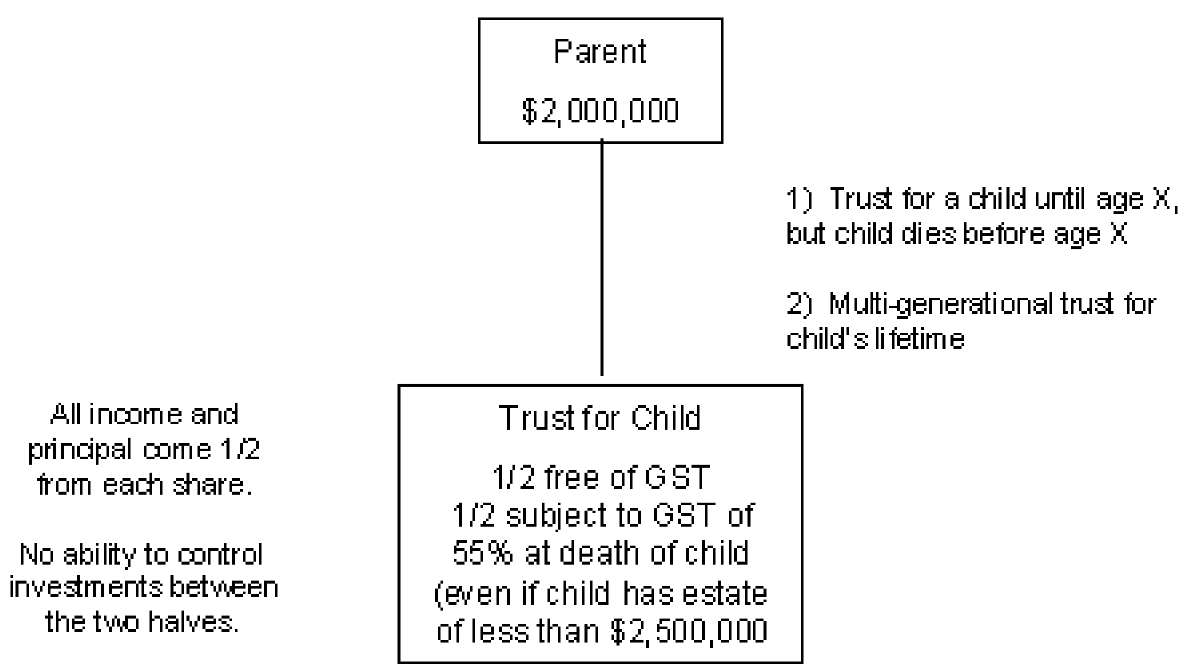
The Problems

The Problem for a Parent Leaving More than $1,000,000 in Trust for Children

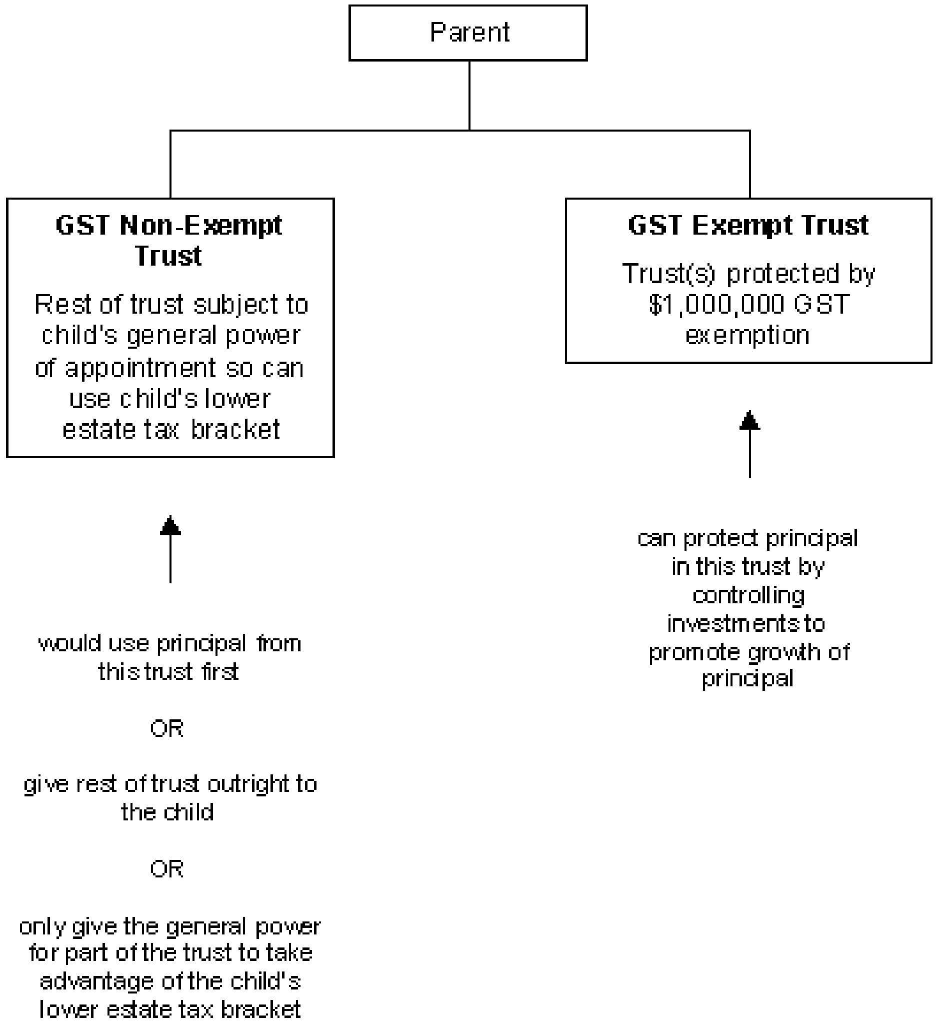
Eventually, Congress became aware that the multi-generational trust was reducing government revenues. To limit "The Solution" shown on page 2, it enacted the generation skipping tax (GST). The GST imposes a tax at the highest estate tax bracket (currently 55%) on each transfer to a generation below the child's generation. Were it not for the exceptions to this rule, there would be no tax advantages of a multi-generational trust. As a matter of fact, unless the child's net worth was at least $3,000,000, the tax impact of the multi-generational trust would be even worse than passing the property outright to each generation. Since the estate tax does not get to the highest estate tax bracket until the estate is worth more than $3,000,000, transfers out of trust would be taxed at a lower rate.

However, careful planning allows us to take advantage of some significant exemptions to the generation skipping tax. The most important exemption is the $1,000,000 GST exemption. Each parent may put $1,000,000 into a multi-generational trust at the parent's death and shelter it from the GST for as long as the trust runs. [This $1,000,000 amount is now indexed to inflation (beginning in 1999). However, since the increased amount is just $1,010,000 this discussion continues to use $1,000,000 in its examples.] If more than its $1,000,000 exemption amount is placed into a trust that has the potential for a generation skip, it is possible that part of the trust will be subject to the GST at the death of the child.

A Problem if a Parent Leaves More Than $1,000,000 in Multi-Generational Trust for Children



The Better Solution

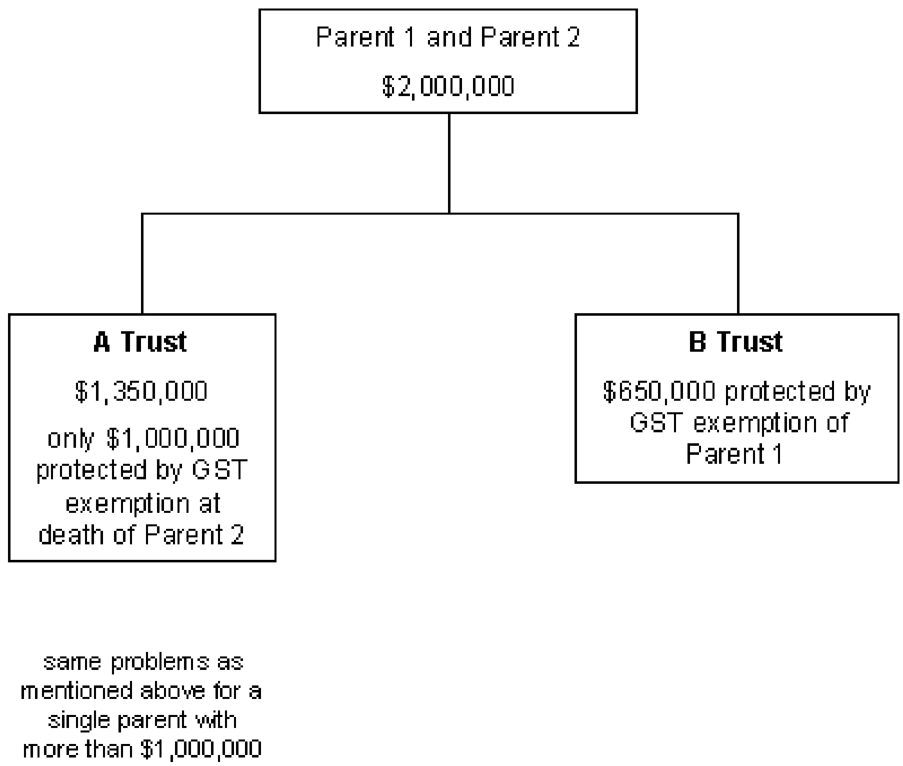


If a parent is likely to leave more than $1,000,000 in trust for a child or children until they reach a certain age or for a lifetime, it is better for the trust instrument to provide that the trust or trusts will subdivide into two trusts: one that is protected by the $1,000,000 GST exemption and one that holds the rest of the assets. It is often a good idea to give the child a general power of appointment over the trust(s) that are not protected by the GST exemption to ensure that the assets are subject to tax in the child's bracket (as opposed to the GST bracket of 55%). The general power of appointment generally means that the child has the power to designate anybody or anything as the beneficiary of the trust after the child's death. However, if the parent has non-tax reasons for limiting to whom the child can appoint to receive the trust, the parent can give the child the power to only appoint the assets to his creditors. If the parent determines that he only wants the child to be able to appoint the trust to the parent's issue, the trust instrument may limit the child's power of appointment to a certain amount of property. If even this solution is not acceptable, the parent will have to face the consequences that each successive generation will be paying the GST tax at the 55% bracket.

The Problem for Two Parents Leaving More Than $1,650,000 in Trust for Children

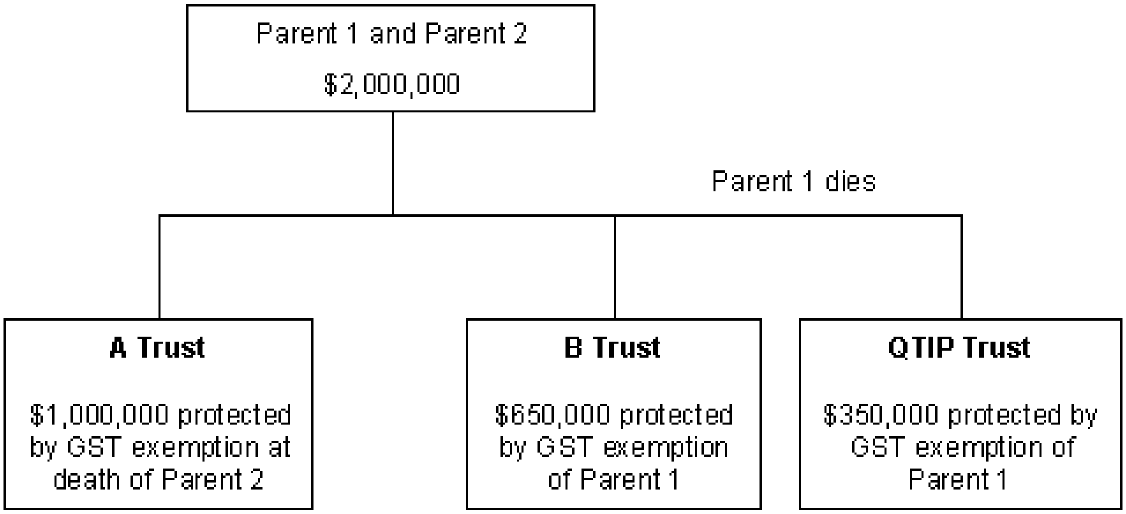
If a married couple establishes a trust for their children that will last until the children reach a certain age or for each child's lifetime, there may be a generation skipping problem if the parents use an AB Trust that holds more than $1,650,000 for the benefit of the children.

A Problem if Two Parents Leave More Than $1,650,000 in Trust for Children



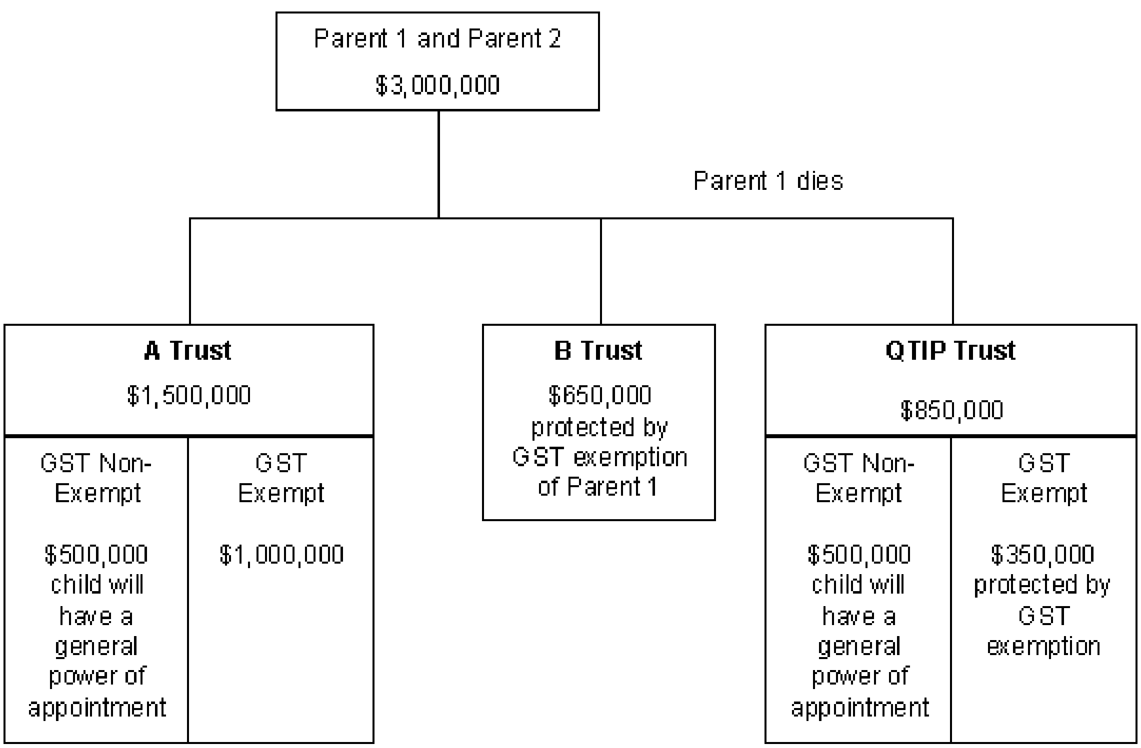
Theoretically, each parent could leave $1,000,000 protected from the generation skipping tax by his or her personal exemption. However, with a regular AB Trust, only $650,000 will go into the B Trust at the death of the first spouse. This will be protected by the $1,000,000 GST exemption of that first parent. However, at the death of the surviving spouse, if the A Trust is worth more than $1,000,000, we have the exact same problem as mentioned above for a single parent leaving more than $1,000,000 in trust for children.

A Simple Solution if Parents Leave Between $1,650,000 and $2,000,000 for Children



By having a QTIP Trust in addition to an AB Trust, we can take advantage of the first spouse's additional $350,000 of GST exemption which is lost in the previous example. This trust structure prevents any generation skipping tax at the death of a child for an estate up to $2,000,000.

A More Complicated Solution if Parents Have More Than $2,000,000



If it is possible that more than $2,000,000 will be left in trust by both parents, each parent has the same problem mentioned above for a parent leaving more than $1,000,000 in trust for children. In that case, it is best to draft the trust instrument so that the A Trust and the QTIP Trust are subdivided down into a GST Exempt and GST Non-Exempt trust or one of the other alternatives shown above for the parent with more than $1,000,000 in trust for children. This saves the most GST and allows both parents enough control over their halves of the living trust. Subdividing the QTIP trust can also be important if the child dies before the surviving spouse.

In conclusion, the multi-generational trust offers significant tax savings and other advantages, but it must be approached prudently in order to avoid the potential problems created by the generation skipping tax law.